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THE CHANGING FACE OF FOREIGN DIRECT INVESTMENT IN JAPAN:
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Summary

The boom in foreign direct investment in the United States in recent years, particularly the stepped-up activities of Japanese corporate investors in the manufacturing, real estate and banking fields, has received extensive media coverage. But little attention has been paid to a parallel development -- the rapid expansion of equity investment in Japan by companies headquartered in the United States and Japan. A new study commissioned by the American Chamber of Commerce in Japan and the Tokyo-based Council of the European Business Community corrects this oversight.

Introduction

Foreign direct investment in Japan has grown an average 16 percent a year since 1980, with commitments by service-sector companies, led by foreign financial service firms, showing the highest growth rate -- an average of 21.5 percent a year since 1981. Foreign machinery makers and chemical and drug firms have been putting in capital at almost as fast a pace. Overall, foreign companies operating in Japan are not struggling for financial viability, and foreign firms no longer consider a Japanese partner essential for getting into the market.

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These are some of the major findings of a new study, the first broadly based reading in eight years of the experience and current corporate strategies of foreign affiliates operating in Japan. Sponsored by the American Chamber of Commerce in Japan (ACCJ) and the Japan-based Council of the European Business Community (EBC), the study was prepared by the Tokyo office of management consultants Booz, Allen & Hamilton, Inc., with assistance by ASI Market Research (Japan).¹

The survey combined confidential polling of almost 400 executives of foreign affiliates, selective follow-up interviews, and an analysis of Japanese, United States and European statistics related to direct foreign investment. The new study, intended to update a 1979 ACCJ study on United States manufacturing investment in Japan, was broadened to include nonmanufacturing industries and direct investments from all OECD countries as well.

Investment Pace and Climate

The foreign presence in Japan's domestic economy, seen in broad outline, has changed little in the past decade. Manufacturing industries account for roughly 60 percent of cumulative direct investment (see Table I), and U.S. companies for roughly half of that investment.

But the study reveals some changes, noted briefly above, in the pace and climate of inward capital flow that diverge sharply from the conventional wisdom about how foreign business operations are faring in Japan.

- Despite the difficulties of market entry peculiar to Japan and the sharply higher dollar cost of entry since the yen's rise starting in 1985, foreign firms are investing more than ever before in establishing or expanding a presence in Japan. Most firms do not cite Japanese government restrictions as a serious barrier to investment. Inward direct investment has grown 16 percent per year since 1980 on average, reaching a new annual high of \$938 million in 1986 (see Table II).²

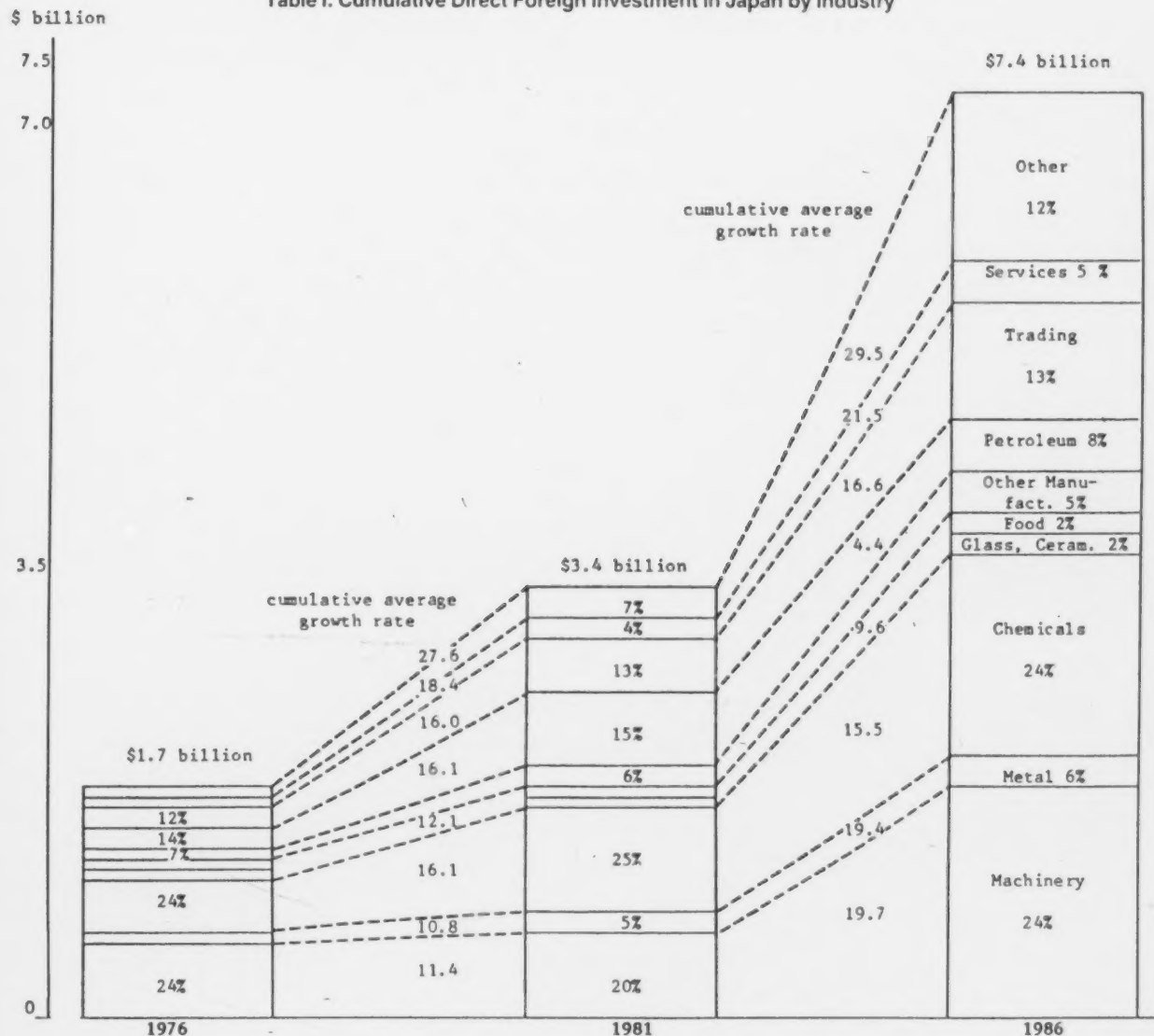
- Led by the inrush of foreign financial service firms after partial deregulation of their markets, direct investment by service-sector companies now shows the highest growth rate in resources committed to Japan (21.5 percent per year average increase since 1981). Yet foreign machinery makers -- with a far larger Japan presence in cumulative investment terms -- have been building in more capital commitment at almost as fast a pace (19.7 percent). And foreign

¹The ACCJ/EBC study, "Direct Foreign Investment in Japan: The Challenge for Foreign Firms," is available at Y3,000 per copy plus Y950 airmail or Y450 surface mail, from: The American Chamber of Commerce in Japan, Fukide Building No. 2, 4-1-21 Toranomon, Minato-ku, Tokyo 105, Japan, Attention: Mr. Henry Sampson.

²In Japan's Ministry of Finance statistics, "direct investment" includes companies in which the foreign investor has more than 10 percent ownership. Figures are based on notification of intent to invest.

chemical and drug firms, already accounting for 25 percent of cumulative inward direct investment in 1981, have maintained a brisk 15.5 percent average annual expansion of that investment.

Table I. Cumulative Direct Foreign Investment in Japan by Industry



- Additional investment by foreign firms already operating in Japan is running higher than capital commitments by newly entering firms.

- A Japanese partner is no longer viewed as essential for plugging in- to Japan's market. Until the mid-1970s, half the equity in a joint venture with a Japanese partner was the most a newly entering foreign firm could hope for under Japan's capital policy restrictions. In the latter half of the 1970s,

with free choice of entry mode, wholly foreign-owned affiliates accounted for 69 percent of foreign investment in newly established firms in Japan. This rose further to 78 percent in the period 1981-85.³

• Overall, foreign firms operating in Japan are not struggling for financial viability. Their return on equity, by Japanese statistics available up to 1983, has roughly matched the Standard & Poor's 400 level since the early 1970s, except in the recession years of 1981 and 1982. From U.S. statistics, return on investment for U.S. firms in Japan has generally exceeded or remained roughly comparable to that for U.S. firms in Europe (see Table III).

Changing Motivations

In the survey of executives on the scene, two perceptions about Japan were by far the leading reasons cited for recent decisions to boost capital commitment in the country -- that there are opportunities to expand sales and profits in Japan, and that Japan is of growing strategic importance to firms that do business worldwide.

Expanded Sales and Profits - First was the perception that the Japanese market offers opportunities to expand sales and profits. In the manufacturing sector, the survey found, the central aim of local production is to meet special requirements of Japanese customers as to quality, delivery and product aspects such as size and packaging.

For many, local production has been critical in achieving significant sales in Japan. Of the manufacturing executives queried, 53 percent claim a major increase in Japanese sales due to the decision to manufacture there. Some 34 percent plan a "significant increase" in the volume of local production over the next five years, and 46 percent expect "some increase." The survey/interview teams found that foreign firms are starting to rely more on contract manufacturing in Japan instead of building their own plants. But in such cases the company's technical development and sales/marketing investments in Japan tend to remain strong.

Unfortunately, the study does not take into consideration the "pull-through" effect of local manufacturing on exports to Japan of raw materials, parts, or related supplies to be sold along with the locally made, tailored-for-Japan items. The ACCJ's 1979 study, carried out by A.T. Kearney International, found that pull-through exports to Japan were substantial in several industries. U.S. manufacturing affiliates in both the drug and electronics/electrical machinery sectors, for example, were then importing more than 40 percent of their raw materials and parts from the U.S., either directly or via a third country. At that time, such pull-through exports from the U.S. were estimated overall at possibly \$650-\$850 million per year.

Strategic Importance - The other main catalyst for further capital input was the growing strategic importance of Japan to firms that do business on a global scale. "For many industries," said Warren Chinn, senior vice president

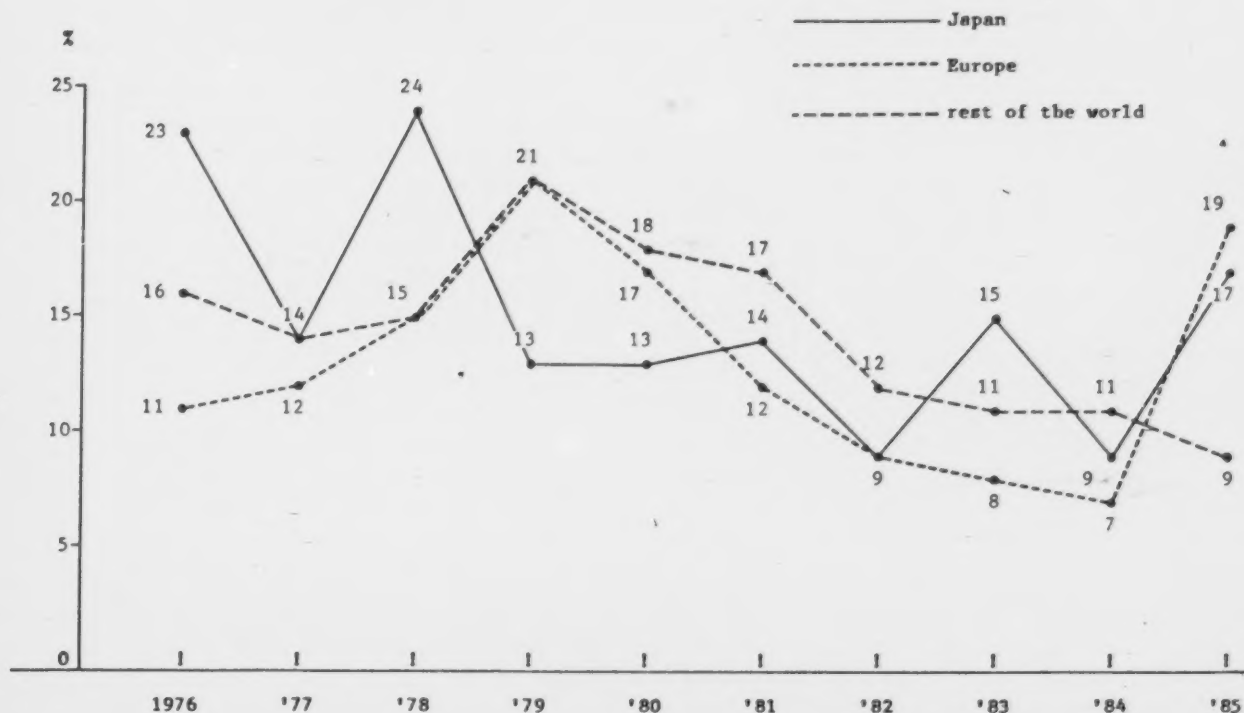
³The actual level is higher, since most new banking and securities affiliates are branches rather than incorporated companies, and as such are excluded from the Japanese statistics.

Table II: Annual Direct Foreign Investment in Japan (Equity Portion)

Year	No. of Cases	Value In US \$ Million	Year	No. of Cases	Value In US \$ Million
1950	30	2.8	1969	391	70.4
1951	38	11.6	1970	455	114.5
1952	31	7.2	1971	445	255.5
1953	22	2.7	1972	747	160.4
1954	14	2.5	1973	756	167.3
1955	9	2.3	1974	655	153.7
1956	23	5.4	1975	615	166.5
1957	22	7.3	1976	652	195.7
1958	18	3.7	1977	693	224.5
1959	21	14.6	1978	705	235.5
1960	34	31.6	1979	704	524.4
1961	41	40.2	1980	749	299.5
1962	43	22.6	1981	919	432.4
1963	92	42.7	1982	1052	749.2
1964	125	30.6	1983	2364	812.9
1965	106	44.6	1984	3685	493.5
1966	142	39.8	1985	3370	929.0
1967	200	32.2	1986	3079	938.0
1968	248	67.1			

Source: Ministry of Finance

Table III. U.S. Companies' Return on Direct Investments in Japan and Other Countries



Source: U.S. Department of Commerce and Booz, Allen & Hamilton Analysis

of Booz, Allen & Hamilton in Tokyo, "this is the most competitive market in the world. A Japan presence strengthens a foreign firm's competitive edge in its home market and other world markets." For example, demands by Japanese customers that may seem extreme may be precursors of similar demands in some of the firm's other markets.

Heavyweights in technology-driven manufacturing industries and in financial services show the greatest interest in direct investment in Japan, Chinn said. And it is affiliates of multinationals that dominate the roster of foreign businesses operating in Japan. (Among the Fortune 100 U.S. companies, for example, 70 have Japan-based operations.) Study team leader K. Rone Baldwin summed up the responses of the multinationals: "If you want to be a global player, you must have a presence in Japan."

Trend in Corporate Strategy - A growing trend in strategy among larger foreign firms, the study notes, is to restructure their Japan presence -- withdrawing from some joint ventures formed earlier with Japanese partners, increasing equity in others, and shifting functions to existing or new wholly owned operations, all aimed at consolidating control of their Japanese business. In particular, large foreign firms with a lengthy history in Japan now find they are overcoming some of the market's complexities, starting to attract top-class graduates, and are better able to fly on their own, Chinn said. In setting up new joint ventures, these companies are now much more selective in choice of partner and of functions the venture is to perform.

Global business sooner or later leads to global technology management, and in the last two years some 20 foreign companies have announced R&D centers in Japan. In some cases, the reason is that the company's leading-edge customers are in Japan, Baldwin explained. In the sharpening competition worldwide for R&D talent, some also want to try tapping such Japanese talent. Some firms surveyed noted they felt a need for a local R&D presence so as to gain adequate access to Japanese technology.

Investment Still Disproportionately Low

Foreign direct investment in Japan, despite its fast growth recently, remains disproportionately low compared to Japanese investment abroad. In 1985, Japan received only three percent of total foreign investment by U.S. companies despite its position as the world's third-largest economy. As of the same year, Japanese government figures show that direct investment abroad by Japanese companies had reached six times the cumulative investments in Japan by foreign companies. While foreign firms got a late start in Japan due to government restrictions on inward investment until the mid-1970s, Japan's own corporate investment overseas was negligible until about 1970.

Three factors were widely cited as the reasons firms already established in Japan are not increasing their capital input at a still faster pace: a long wait for profitability, and the complexity and difficulty of doing business in Japan and of recruiting good personnel.

The Wait for Profitability - First is the long time required to reach acceptable profit levels in Japan compared to alternatives in other markets. Further questioning revealed that for the affiliates surveyed, it took about four years on average to break even and about seven years to reach corporate

average profit levels. There was little difference between wholly owned operations and foreign/Japanese joint ventures in this regard.

"There is some evidence," the study comments, "that the long [wait for profitability] is more a perceived problem than a real one. . . . Although each company has its own hurdle rates for profitability, these time frames do not appear particularly long for many corporations." The real problem, the study concludes, may be uncertainty due to the rather wide range of the actual time frames that made up the averages: from 3.8 to 10 years to reach corporate average profit level in two-thirds of the cases for wholly owned subsidiaries.

Difficulty in Doing Business and Recruiting - The widely varying performance among companies in reaching profitability could well stem from the other two most often cited barriers to greater investment by foreign companies: the sheer complexity and difficulty of doing business in Japan and of recruiting good personnel.

Some fairly familiar problems are involved, such as trying to build effective sales channels in Japan's Byzantine distribution system; the strong Japanese aversion to breaking long-established ties with an entrenched supplier; and trying to establish an "insider" image in a country where outsiders -- foreign or Japanese -- are not easily accepted. Top-flight university graduates, favoring major firms, tend to see a foreign affiliate as a modest-sized newcomer rather than as the local projection of a multinational corporation, and mid-career professionals fear loss of the career development programs in which Japanese corporations blanket them should they sign on with a "profits first" foreign firm.

There is no single solution to any of these problems, but the study notes "an increasing, conscientious effort by foreign companies to win by managing themselves like Japanese companies."

Overseas Problem - Of those queried, 18 percent listed an overseas problem as their number one or number two investment barrier: lack of understanding or poor perception of opportunities in Japan by corporate management in the home country. The responses suggested that this may be a serious barrier in the transportation equipment and electronics/telecommunications industries.

Regulations and Non-Tariff Barriers - Japanese government regulations and non-tariff barriers came last, cited respectively by only 13 percent and nine percent of respondents as their most serious or next most serious restraint on further investment. But in many cases the firms of those respondents are in two of Japan's most dynamic industries: financial services and telecommunications.

Among other persisting complaints are the exclusion of foreign firms from much government procurement and contracting; a wide range of product licensing and registration requirements; import quotas and other restrictions that cripple food processors' access to imported ingredients; and limitations imposed by the government's pharmaceuticals registration system. Various forms of exclusion from the domestic business community, such as difficulty in joining Japan's ubiquitous industry associations, are also a continuing problem.